Nos. 20,159-20,174

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Commissioner of Internal Revenue, *Petitioner,*

v.

Seaboard Finance Company,
Seaboard Finance Company, Transferee,
Seaboard Finance Company of Lynwood,
Seaboard Finance Company of Monterey,
Seaboard Finance Company of Northern California,
Seaboard Finance Company of Colorado Springs,
Seaboard Finance Company of Denver, Two,
Seaboard Finance Company of Denver, Three,
Seaboard Finance Company of Denver, Four,
Seaboard Finance Company of Denver, Five,
Seaboard Finance Company of Pueblo, Two,
Seaboard Finance Company of Connecticut, Inc.,
Seaboard Finance Company (Idaho),
Seaboard Finance Company of Terre Haute, Inc.,
Seaboard Finance Company, Inc. (Massachusetts),
Seaboard Finance Company of Flint, *Respondents.*

Seaboard Finance Company, et al., *Cross Petitioners,*

v.

Commissioner of Internal Revenue, *Cross Respondent.*

On Petitions for Review of the Decisions of the Tax Court of the United States

BRIEF FOR RESPONDENTS AND CROSS PETITIONERS

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BRIEF FOR RESPONDENTS AND CROSS PETITIONERS

I INTRODUCTION

OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R 41-112) are not officially reported, but are unofficially reported at 23 CCH Tax Ct. Mem. Dec. 1512 and 1964 PH Tax Ct. Mem. Dec. 1655 (1964).

JURISDICTION

These consolidated petitions for review (I-R 129-131) and cross petitions for review (I-R 132-134) involve federal income taxes for fiscal years ending in 1955, 1956, 1957, and 1958. By his notices mailed to Seaboard Finance Company and fourteen of its subsidiaries ("Seaboard" hereafter) on March 2, 1962 (I-R 1) the Commissioner determined deficiencies in the aggregate amount of some $621,000. (I-R 42-43) Within ninety days thereafter and on May 24, 1962, Seaboard filed petitions for redetermination with the Tax Court, pursuant to Int. Rev. Code of 1954, § 6213. (I-R 1-5) The decisions of the Tax Court, redetermining the deficiencies at about $202,000, were entered on December 16, 1964. (I-R 113-128) The case is brought to this Court by petitions for review filed by the Commissioner on March 10, 1965 (I-R 129-131), and by cross petitions for review filed by Seaboard on April 16, 1965 (I-R 132-134), all within the time prescribed in Int. Rev. Code of 1954, § 7483. Jurisdiction is conferred on this Court by Int. Rev. Code of 1954, § 7482.

QUESTION PRESENTED

Must this Court set aside as "clearly erroneous" the Tax Court's finding of fact that Seaboard paid 70 per cent of the amounts in question as a premium on small loan contracts?

STATUTE AND REGULATIONS INVOLVED

Int. Rev. Code of 1954:

SEC. 167. DEPRECIATION.

(a) **General Rule.**—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) —

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * *

Treas. Reg. § 1.167(a)-3 (1956) (amended, T.D. 6452, 1960-1 Cum. Bull. 127):

Sec. 1.167(a)-3 **Intangibles.**

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.

STATEMENT OF FACTS[1]

During the years between 1953 and 1958 Seaboard acquired assets of a number of small loan companies. (II-R 16, 29, 154-55) In all but two of these acquisitions Seaboard purchased all the assets of the selling company. In each case the principal assets acquired were small loan contracts. (Stip. gen.; II-R 17)

The small loan company renders a special service which meets the needs of borrowers who do not need or cannot avail themselves of the services of banks and other major lending agencies. The interest rates charged on large loans would not return the cost of overhead, credit investigation, interest expense, and servicing if applied to loans of under $500. For this reason the laws of the various states allow higher interest rates for loans of small size and relatively short duration. However, to prevent abuse, companies in the business of making such loans are licensed and strictly supervised.

The terms of such loans are governed by law in every state. Maximum interest rates are prescribed on a sliding scale varying inversely with the amount of the loan. For example, in California at the time the contracts in question were made the maximum interest rate on loans

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[1] A Stipulation of Facts with Exhibits 1-A through 77-KKK annexed was filed. At the trial three witnesses for Seaboard testified and Seaboard's Exhibits 78 through 88 were admitted into evidence. The Government (hereinafter referred to as the Commissioner) offered no oral testimony nor did it place any exhibits in evidence.

Reference to the evidence will be shown in the brief as follows:

Stipulation of Facts, by paragraph, thus: Stip. 33; Record, by volume and page, thus: II-R 69; Exhibits, by number, thus: Exh. 77-KKK; Exh. 83

of \$100 or less was 2½% per month. The rate on the next \$400 was 2% per month. (II-R 90, 165) The maximum term of such loans is restricted by the laws of the various states to from 20 to 36 months. (II-R 42,131)

The typical borrower under a small loan contract will require a longer term to repay than the original contract provides, or will need additional money before his loan is fully repaid. This results in "refinancing," or replacing his existing contract with a new one two or three times before the loan is fully paid, making the total loan period about three to five years. (II-R 130,175)

Because of state regulation and the needs of borrowers, small loan contracts have certain unique characteristics which distinguish them from other securities such as bonds, mortgages, debentures and commercial notes. These characteristics are: (1) a comparatively high rate of interest; (2) a comparatively short duration; (3) a borrower with an unproven payment record; and (4) the probability that the borrower will seek to refinance his contract, extending its life to from three to five years.

In all but two of the purchases here involved Seaboard determined the value of the loan contracts it purchased by a method commonly used in the small loan industry called "spreading" the contracts. (II-R 50, 73) Spreading loan contracts consists of an examination of each contract and of the file of information concerning that particular contract and its borrower. (II-R 51) Here the spreading was performed by experienced representatives of Seaboard. (II-R 50)

When performing a spread, the expert lists in columns the identification number of each contract, the name of the borrower, the principal balance due, and assigns a rating or classification of the individual contract. Such

a listing (derived from Exhibit 17-Q) might appear as follows:

SCHEDULE

Account No.	Name	Present Balance	Class
A-1368	Alojipan, S.	$262.31	A+
FV-144	Allen, Don D.	70.88	A
S-1384	Herndon, J. E.	357.92	B
S-732	Harris, Sherman	151.12	C
S-1025	Haxcall, Charles	72.85	D

The usual classification symbols are A+, A, B, C, D, and E. In assigning each contract to a class, the person performing the spread scrutinizes all the information in the file which will give any hint as to the probability that the borrower will make timely payment of his loan. The Seaboard representative pays particularly close attention to the actual payment record of the borrower on the particular contract being scrutinized. (II-R 89-90) He also ascertains the age of the borrower, his employment and salary, his seniority in his job, whether his wife is employed, number of dependents, his monthly budget, his other debts, and the results of any credit check contained in the file. (II-R 231) On the basis of this information he classifies each loan contract in categories A+ through E.

When the Seaboard representative has classified the loan contracts he computes the total of the principal remaining to be repaid ("principal balance") for the contracts in each class. He then adds a percentage premium to the aggregate principal balance of the A+ account contracts and subtracts a discount from the aggregate principal balances in the B, C, D, and E categories. In the purchases involved in this case premiums varied between 15% and 30%. Discounts were typically 25% on the B contracts, 50% on the C contracts, 75% on the D contracts, and 100% on the E contracts. (II-R 56, 62,

198, 229-30) Loan contracts in the A category were purchased at an amount equal to the aggregate principal balance. (II-R 55)

The determination of the premium to be paid upon the A+ contracts depends upon several factors. First, the premium will vary with the effective yield obtainable on small loan contracts under the laws of the state in which the contracts are written. (II-R 89, 92, 231) Because the maximum permissible rates vary from state to state, the effective yield on loan contracts will vary accordingly. (II-R 51, 208, 231) Second, the percentage premium will be higher if the average balance on the loan contracts purchased is low. This results from the fact that the effective yield on low-balance contracts is higher than the effective yield on comparatively high-balance contracts since the interest rate charged varies in inverse proportion to the amount of the principal balance outstanding. See p. 4, *supra*. (II-R 90)

Third, if the overall quality of the loan contracts being spread, compared with contracts in other loan offices, is good the percentage premium will be relatively higher. (II-R 234)

The fourth factor affecting the percentage premium Seaboard pays is supply and demand. If there are competing purchasers for the loan contracts, the Seaboard representative, like anyone valuing a commodity in a competitive situation, may increase the premium in order to be better assured of making the purchase. (II-R 92)

Typically the Seaboard representative who is spreading loan contracts will make a summary sheet at the conclusion of his spread. These sheets (see *e.g.*, Exhs. 78, 84), which were made by persons in the field before the tax treatment of these amounts was drawn into question by the Commissioner, show the actual computation of

premiums and discounts on loan contracts. (II-R 63, 65, 87, 125) The following is a representative excerpt from Exh. 78 showing such a summary sheet:

	TOTAL	A+	A	B	C	D
SPREAD SHEET TOTALS	$152,169.27	73,874.08	63,967.71	8,801.00	4,371.44	1,155.04
GRADING	5,828.86	11,081.11		(2,200.25)	(2,185.72)	(866.28)
NET	$157,998.13	84,955.19	63,967.71	6,600.75	2,185.72	288.76

Loan contracts are worth a premium to Seaboard because they are a profitable investment. They produce a high rate of interest over a five-year period. For several reasons prime quality purchased loan contracts are even more valuable to Seaboard than those which Seaboard itself originates. In the purchase situation Seaboard has better credit information on the borrower in the form of an actual payment history for the specific contract being purchased. (II-R 89-90, 177) Seaboard, therefore, is better able to determine the probability of complete and prompt payment and more accurately to determine the effective yield the contract will produce. Also, Seaboard's effective yield will be increased on a purchased contract because Seaboard will have no expenses for advertising, overhead, and credit checking. (II-R 150, 177)

In 1956 Seaboard purchased approximately $27,000 worth of loan contracts from U. S. Finance Co. in Los Angeles. (Exh. 88; II-R 235) U. S. Finance Co. remained in business, retaining the remainder of its loan contracts, all of its employees, its location and its name. (II-R 237) Seaboard serviced the contracts it had purchased at one of its own offices. Despite the fact that Seaboard received no office location, license, name, personnel, or going business, Seaboard paid a premium for the U. S. Finance contracts identical to that it paid on contracts acquired in purchasing in California the assets of two of the loan offices involved in this case. (II-R

234-37) These were Barnett Car Co., purchased in April 1956 and Rapid Thrift Co., purchased in July 1957.

Seaboard also purchased loans from Gulf Finance Company Mt. Rainier, Inc., paying a premium of 23 per cent though the seller remained in business at its location, retaining its license, employees and the bulk of its loan contracts. (II-R 93-94)

The secured and unsecured loan contracts here in question had useful lives in Seaboard's business of three and five years respectively. (II-R 130)

The Commissioner's Statement of Facts at pages 4 through 8 of his brief is generally accurate. However, at page 5 the Commissioner states that "Taxpayers would not buy an office if they could not acquire the seller's small loan license by transfer." This sentence perpetuates an inadvertent misstatement in the Tax Court's opinion. (I-R 47) Small loan licenses are not transferable and therefore none of the sellers transferred its license to Seaboard. The Tax Court's opinion notes at I-R 56:

> Seaboard did not allocate any part of the purchase price for the acquisition of a small loan license. In each case Seaboard had to apply for and receive a license in its own name before it was permitted to operate at the seller's location. Many of the acquisitions were contingent upon the issuance to Seaboard of a license to Seaboard at the seller's location.

SUMMARY OF THE ARGUMENT

Seaboard, in the years in question, acquired by purchase the assets of a number of small loan offices. The dispute in this case involves a portion of the purchase price which we shall call the "premium." Seaboard asserts that the purchase price of each loan office was equal only to the net value of its assets and that no allowance was made for goodwill. The Commissioner asserts that a certain portion of the purchase price, computed as a premium on purchased loan accounts, was in reality a disguised payment for goodwill. This is an issue purely of fact.

In the Tax Court Seaboard offered more than 120 pages of direct testimony and introduced 88 exhibits into evidence. On the basis of that testimony and those exhibits, Judge Dawson of the Tax Court concluded that 70 per cent of the disputed payments were in fact made as part of the purchase price — as a premium on — loan contracts. On this basis amortization was allowed. This finding of fact by the Tax Court as to the 70 per cent is based upon substantial and persuasive evidence; we believe that it cannot properly be held to be "clearly erroneous" under Fed. R. Civ. P. 52(a).

Seaboard's evidence before the Tax Court showed that none of the disputed amount was paid to acquire employees, licenses, locations, or business names. The testimony of Seaboard's two witnesses with respect to the disputed amounts was lengthy, detailed and explicit. Each of these witnesses testified that the disputed amounts were *in fact* paid as part of the purchase price of the loan contracts. Seaboard's documentary evidence, prepared concurrently with the sale and long before the trial, substantiated the specific statements of Seaboard's witnesses. This testimony and these documents show

that small loan experts will in fact value a small loan contract with a principal balance of $100 at an amount varying from a high of $125 to a low of $25 or $0. The Commissioner has arbitrarily allocated all of the premium (*i.e.,* that part of the price in excess of the aggregate face amounts of the loan contracts) to goodwill.

In effect the Commissioner maintains that the principal balance owing on any given loan contract is the only measure of its value and that each loan contract with the same principal balance must be worth the same amount. The testimony of Seaboard's witnesses reveals a large number of other factors which will affect the value of loan contracts and which may cause two loan contracts with the same principal balance to be worth widely differing amounts. Among these factors are the amount of interest the contract pays, the credit status of the borrower, the saving in indirect loan costs, and the probability that the loan will be refinanced.

Although the typical small loan contract is written for an initial term of between 20 and 36 months, it is usually extended by one or more "refinances" to a total term of approximately five years. Seaboard's use of a five-year useful life with respect to the premiums paid for many of the contracts here involved acknowledges its understanding of the role of this refinance. Indeed, on direct testimony Seaboard's witnesses acknowledged that this attribute of the small loan contract is one which makes it more valuable than it would otherwise be. This is true because of the fact that a contract subject to refinance will remain on the books as an income-producing asset for a longer period than if it could not be refinanced.

Seaboard purchased single items of negotiable commercial paper, having the characteristics which such

paper generally has. One such characteristic is that the maker of the paper will usually seek to refinance the obligation by increasing the amount and/or the term thereof. This characteristic adds value to such contracts, but this is true whether a large number of such contracts is acquired through the purchase of the assets of a small loan office, or a single such contract is acquired. In either case the added value is a characteristic of the paper, and cannot be attributed to the fact that it was written by a certain office or company. Thus it is clear that the premiums paid by Seaboard on small loan contracts were paid for the peculiar value of such contracts and not for goodwill. Such premiums are amortizable just as premiums on negotiable paper generally may be amortized.

Seaboard presented evidence to the Tax Court of the limited useful life of the contracts here involved. Since the Commissioner's brief neither raises the question of limited useful life nor argues that a contract right as such is not deductible, Seaboard has made no argument on those points but will simply direct the Court to Treas. Reg. § 1.167(a)-3 (1956) (amended T.D. 6452, 1960-1 Cum. Bull. 127). These regulations permit a depreciation deduction for the amortization of the cost of intangible assets if the life of the intangible can be estimated with reasonable accuracy. Not only the courts but also the Commissioner concedes that a contract right with a limited useful life is the proper subject of such an amortization deduction. 1954-1 Cum. Bull. 6, *acquiescing in Stewart Title Guar. Co.,* 20 T.C. 630 (1953); 1957-1 Cum. Bull. 4, *acquiescing in Francis E. Latendresse,* 26 T.C. 318 (1956), aff'd, 243 F.2d 577 (7th Cir. 1957), *cert. denied,* 355 U.S. 830, 78 S.Ct. 43, 2 L.Ed.2d 43 (1957).

The Commissioner here argues that this case is an appropriate one for application of the "indivisible asset" rule. The essence of this rule is that where a taxpayer

purchases a bundle of assets as in a corporate acquisition, he cannot separately amortize the cost of customer contracts unless he may separate these contracts from the bundle by proving that they have independent value and that he has paid an identifiable consideration therefor. Seaboard has here met this burden and therefore cannot be denied its deductions under the indivisible asset rule.

On the basis of the evidence below and the authorities the decision of the Tax Court must be sustained.

Should the Court reject Seaboard's argument that the decision below cannot be set aside, Seaboard submits that the evidence establishes that 100 per cent of the premium was paid for loan contracts. The evidence further tends to prove that the sellers from whom Seaboard purchased assets had no goodwill. For these reasons this Court should remand the case with instructions to enter judgment for Seaboard.

II RESPONSE TO COMMISSIONER'S BRIEF

ARGUMENT

THE DISPUTED AMOUNTS WERE PAID BY SEABOARD FOR LOAN CONTRACTS, NOT FOR GOODWILL.

A. The Contested Findings of the Tax Court Are Factual, Are Supported by Substantial Evidence, and Cannot, Therefore, Be Set Aside as Clearly Erroneous.

The Tax Court reported as part of its "Ultimate Findings" the following facts:

> Seventy per cent of the excess consideration paid over the sellers' net book value of the assets sold was attributable to the small loan contracts and 30 per cent of the excess consideration was paid for goodwill and going concern value of the small loan business acquired.

The Commissioner specifies in his brief three alleged "errors," all of which are merely restatements of his contention that the above findings are in error. As such, his contention is not that the court erroneously applied the law, but that the court did not correctly adduce the facts from the evidence presented.

It is a well-established rule of tax law that where a statutory term such as "goodwill," "gift," "value," or "ordinary and necessary" is properly defined so as to establish the criteria for its application, the application of such a term to a particular case is purely a question of fact. See, *e.g., Helvering v. Maytag,* 125 F.2d 55, 62 (8th cir. 1942); *Commissioner v. Heininger,* 320 U.S. 467, 475, 64 S.Ct. 249, 254, 88 L.Ed. 171, 177 (1943). "Whether an expenditure is directly related to business and whether it is ordinary and necessary are doubtless *pure questions of fact* in most instances" (emphasis

added); *Commissioner v. Duberstein,* 363 U.S. 278, 287-291, 80 S.Ct. 1190, 1198-1200, 4 L.Ed.2d 1218 (1960); *Johnson v. United States,* 45 F.Supp. 377, 379 (S.D.Cal. 1941); *Commissioner v. Peterman,* 118 F.2d 973, 976 (9th cir. 1941); *Dunbar v. Commissioner,* 119 F.2d 367, 369 (7th cir. 1941); *Sportwear Hosiery Mills v. Commissioner,* 129 F.2d 376 (3rd cir. 1942); *Lydia E. Pinkham Medicine Co. v. Commissioner,* 128 F.2d 986, 990 (1st cir. 1942); *Hirsch v. Commissioner,* 124 F.2d 24, 28 (9th cir. 1941).

That the question as to whether payments are made for goodwill is purely a question of fact was recognized by the Tax Court in *American Fork and Hoe Co.,* 12 P-H Tax Ct. Mem. 1369, 1371, 2 CCH Tax Ct. Mem. 842 (1943):

> The issue, thus, is . . . whether or not petitioner paid any part of the total consideration for goodwill. . . .
>
> This question is purely one of fact which must be determined from the evidence before us. . . .

That great weight must be given by an appellate court to the determinations of the trial judge in resolving questions of fact is no doubt so familiar to this Court that extensive citation of authorities is unnecessary. Rule 52 of the Federal Rules of Civil Procedure provides in part:

> Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of witnesses . . .

In *Commissioner v. Duberstein, supra,* the Supreme Court has said at page 291:

> Where the trial has been by a judge without a jury, the judge's findings must stand unless "clearly erroneous." Fed. Rules Civ. Proc. 52(a), 28 U.S.C.A. "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." United States v. United States Gypsum Co., 333 U.S. 364, 395, 68 S.Ct. 525, 542, 92 L.Ed. 746. *The rule itself applies also to factual inferences from undisputed basic facts,* id., 333 U.S. at page 394, 68 S.Ct. at page 541, as will on many occasions be presented in this area. Cf. Graver Tank & Mfg. Co. v. Linde Air Products Co., 339 U.S. 605, 609-610, 70 S.Ct. 854, 856, 857, 94 L.Ed. 1097. And Congress has in the most explicit terms attached the identical weight to the findings of the Tax Court. I.R.C. § 7482(a), 26 U.S.C.A. § 7482(a). (Emphasis supplied.)

There are at least two important policy reasons for which appellate courts should overturn a factual determination made by the court below only in exceptional circumstances. Even if a present-day appellate judge's work load permitted him to examine a bulky record minutely, he would not have the same opportunity to determine the facts as did the trial judge. Experience tells that a written description of an actual event is a pale and incomplete statement of what actually occurred. One can accurately describe a performance by Yehudi Menuhin as the drawing of taut horsehair over stretched catgut to produce a high-pitched sound. This is an accurate but scarcely complete description of a performance by a violin virtuoso. So, too, a written trial record is a pale and incomplete portrayal of the drama which occurred in the trial court. The reviewing judge cannot reconstruct from the record the nervous laughter, voice

inflection, averted eyes, reddened ears, or sweating hands of the witness. The "clearly erroneous" rule, therefore, is founded partly on the basic fact that an appellate judge, however diligent, can never really *know* the evidence below as well as the trial court can know it. See, *e.g.*, *United States v. Yellow Cab Co.,* 338 U.S. 338, 341-42, 70 S.Ct. 177, 179, 94 L.Ed. 150 (1949).

It is sometimes argued that reddened ears and sweating hands are only important when there is contradictory evidence before the trial judge. In *United States v. First Security Bank,* 334 F.2d 120 (9th Cir. 1964), this Court has answered that argument as follows:

> Although the existence of all these factors is not in dispute, and although the trial court's findings do not involve any problem of credibility of witnesses, yet we think its findings are subject to the requirements of Rule 52(a), Fed. Rules Civ. Proc. that they should not be set aside unless clearly erroneous. (At page 121).

Anyone who has seen an able Government attorney conduct a case on a limited budget will understand the merit in the court's ruling. Such an attorney can probe and question the veracity of the taxpayer's witnesses almost as well by use of a searching cross-examination as could be done by the presentation of contrary evidence. In the present case the Commissioner's counsel did in fact draw the testimony of Seaboard's witnesses into question by his cross-examination. (See, *e.g.,* II-R 158, 162, 178)

Thus even where there is no contradictory testimony the trial judge is called upon to determine when the witness has stretched the truth, when he has made convenient omissions, in short when he has lied. This then is the most important consideration urging restraint on

appellate courts: that the appellate judge sees only an imperfect and hazy reflection of what the trial judge saw, sensed and felt.

A second and related policy consideration supporting the "clearly erroneous" rule is that the proper administration of justice requires that the factual determination of the trial court, except in rare cases, must stand. In today's complex society the courts are crowded with deserving litigants. Appellate courts should not foster appeals unless there is a substantial probability that the second sitting will produce a better outcome. Surely the determination of a factual issue is not one of those cases in which the probabilities of a correct decision are greater at the appellate level than at trial.

If the Court applies the "clearly erroneous" test in this case, we believe it can come to only one conclusion: that the finding below was *not* erroneous, but was supported by substantial evidence. The record contains 115 pages of direct testimony by Mr. Weidman, President of Seaboard (II-R 36-151); 12 pages of direct testimony by Mr. Lide, Vice-President of Seaboard (II-R 226-38); and 88 exhibits of Seaboard. All of that testimony and each of those exhibits added in some measure to Seaboard's case. Both Mr. Weidman and Mr. Lide testified in explicit detail about the various purchases and the factors which made the loan contracts worth a premium to Seaboard. (See, *e.g.*, II-R 229-30) The exhibits corroborated that testimony. (See, *e.g.*, Exh. 78, 79, 84, 88) Surely this evidence is "substantial"; certainly no finding in accord with it can be said to be *clearly* wrong.

We submit, therefore, that this case is a fact dispute and little else. Respondent has attacked the truth of Seaboard's contention by explicit questions on cross-examination. If Seaboard's witnesses accurately por-

trayed the transaction involved, Seaboard should prevail; if those witnesses bent the truth, Seaboard should lose. The Tax Court was convinced that Seaboard's evidence established that small loan contracts are more valuable than their face amounts; that evidence was substantial and was not contradicted or qualified. Important policy considerations, the decisions of this Court, and those of the Supreme Court support the doctrine that an appellate court must use great restraint in exercising its power to upset the factual finding of a lower court. On the record presented we believe that the Tax Court's findings cannot properly be said to be clearly erroneous.

B. The Evidence Clearly Establishes That the Loan Contracts Were Worth More Than Face Amount, and That the Contested Payments Were Made as Part of the Purchase Price of Such Loan Contracts. Nothing Was Paid for Goodwill.

Seaboard's position in this case can be summarized in a brief sentence — Seaboard paid more than face value for the loan contracts because they were worth more than face value. This proposition being true, nothing was paid for goodwill. The Trial Court adopted and used the definition of goodwill of Mr. Justice Story quoted in *Metropolitan National Bank of New York v. St. Louis Post Dispatch,* 149 U.S. 436, 446, 13 S.Ct. 944, 948 (1893):

> Goodwill [is] the advantage or benefit which is acquired by an establishment beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for

> skill or affluence or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.

If goodwill is the worth of a business exceeding the value of its "capital, stock, funds, or property" then it follows that if a buyer pays only the value of the assets of a business, nothing has been paid for goodwill.

The evidence adduced at trial conclusively establishes that the loan contracts had a value at least equal to the price allocated to them. This evidence can be summarized in the following four categories:

1. Mr. Weidman, President of Seaboard, testified without contradiction or qualification that Seaboard paid no part of the disputed amount for those things which are almost always associated with goodwill. He testified that nothing was paid to acquire the selling company's employees. (II-R 98-104, Exh. 80) Seaboard did not use the name of the selling company after the purchase in any case. (II-R 104) Finally, he testified that Seaboard paid no amount for the acquisition of any of the seller's locations or leases. (II-R 109, 110) Thus the evidence is clear that Seaboard paid nothing for name, location, or personnel, the attributes which are commonly associated with goodwill.

   Rather Mr. Weidman and Mr. Lide, men of extensive experience in the consumer finance industry, testified that the disputed amounts were paid as premiums on — as part of the price of — loan contracts. Each of them explained in explicit detail the method by which Seaboard valued the loan contracts to be purchased and the reasons for such valuation. (II-R 53 *et seq.*, 233 *et seq.*)

The unsophisticated person may be likely to value an imitation pearl for the same amount as a genuine twin, yet the expert jeweler instantly recognizes characteristics which make the authentic pearl worth hundreds of dollars more than its spurious but apparently identical twin. Likewise, the unsophisticated layman may regard one loan contract calling for the payment of a given principal balance at a given rate of interest as roughly the equivalent of every similar loan contract. However, a consumer finance expert may value one such contract at 25% of the principal balance and value the other at 125% of the principal balance.

The process of "spreading" or evaluating loan contracts gives striking examples of this disparity in value. Before the purchases here involved, a representative of Seaboard inspected and evaluated *each individual* loan contract to be purchased. (II-R 50, 52) In the course of this examination an expert from Seaboard examined the file the seller kept on each of its loan contracts. This file contained all the credit information on the obligor and would include a record as to the timeliness and number of payments which the obligor had made on the loan contract. In the typical case here involved, Seaboard's expert valued some contracts at 115-125% of face (A+); some at face (A); and others at 75% (B), 50% (C), and 25% (D) of the amount of principal owing on that contract.

The value Seaboard placed on each loan contract varied in proportion to its estimation of the credit situation of the obligor. Mr. Lide, who often "spread" accounts, testified that he determined this credit status by looking at:

> [The obligor's] age, his type of job, his position on the job, length of service on the job, whether his wife works; does he have a big family — a number of dependents.
>
> We want to determine the amount of the payments in relationship to his income to see that he can pay the payments comfortably, without any hardship, and you want to look at his past credit records and his record of paying on the account involved. (II-R 231)

After Mr. Lide had evaluated all of these factors as an expert he placed a value on the loan contract.

Both Mr. Lide and Mr. Weidman testified that the Seaboard experts did *in fact determine that specific loan contracts had a value greater than the face or principal amount owing on those contracts.* This testimony was unimpeached and not contradicted. The Commissioner offered no experts to refute this point. These facts stand as persuasive support for the finding of the court below — that the disputed amounts were *in fact paid for* loan contracts. Indeed, a finding to the contrary would be clearly erroneous.

2. Examination of certain of Seaboard's exhibits provides even more convincing evidence that Seaboard did in fact determine that the value of certain individual loan contracts was higher than their face amount. For example, the Court's attention is directed to Exhibits 17-Q and 78. 17-Q is a representative part of the 11-page list of loan contracts attached to the purchase agreement. Each loan was evaluated as "A+" through "D" before it was added to the list. Exhibit 78 is a tabulation of the evaluated loans. It shows the addition of a premium to

the A+ accounts and the subtraction of a discount varying from 25% to 75% from others.

These are not documents prepared by a tax expert with a view toward future tax avoidance; they are actual documents prepared concurrently with the purchase by experts in the loan field having no training in corporate taxation. (II-R 63) Yet these documents show the actual valuing of individual loan contracts by number and balance; they show the addition of a premium and the subtraction of a discount from specific loans. They are entirely consistent with the testimony of Mr. Lide and Mr. Weidman and with the finding of the Tax Court. They are inconsistent with the Commissioner's argument. The Commissioner offered no evidence to refute the values listed on these worksheets.

3. Most of the purchase agreements provided for a basic sales price based upon the value of loan contracts outstanding at the time the agreement was signed. In most cases the purchase was not consummated until some later time. Typically the purchase agreements provided for a price adjustment for loans which were paid in part or in full and for new loans which might be made between the time of the signing of the agreement and the final settlement. One of these agreements (Exh. 6-F) calls for the reduction of the total purchase price by 127½% of the amount which any debtor pays on an A+ contract between the time of the agreement and the time of the final settlement. Another calls for Seaboard's purchase of new A+ accounts by paying the principal balance plus an additional amount equal to "25% of the balance." (Exh. 57-EEE) Another seller (Exh. 26-Z) agreed to repurchase bad loan contracts from Seaboard by the payment of the

principal amount due "plus the amount of bonus paid therefor."

Each of these agreements contemplated the addition or subtraction of a specific amount of premium with respect to *each single* loan contract which should be repurchased, added, or paid in the period between signing of the contract and closing the transaction. If the premium were in fact a disguised payment for goodwill and not payment for specific loan contracts, it is unlikely that the parties would have gone to the trouble to make such minute and complex adjustments. The addition or subtraction of a few loan contracts could not cause the value of any existing goodwill to fluctuate significantly. Had the premium been simply a disguised payment for goodwill, these adjustments would have been unnecessary.

4. Perhaps the most persuasive evidence in this case is the purchase of contracts by Seaboard from U. S. Finance Co. and from Gulf Finance Mt. Rainier, Inc. In these purchases Seaboard acquired only a portion of the loan contracts owned by the seller. Seaboard took over none of the sellers' employees nor did it do business at the sellers' location or acquire the sellers' names. The sellers remained in business at their former addresses with most of their existing customers. All Seaboard received from the sellers were certain of their high quality loan contracts. Despite these facts Seaboard paid a 15% premium for A+ accounts of U. S. Finance Co. (II-R 235-37) and 23% for A+ accounts of Gulf Finance (II-R 94). The U. S. Finance Co. premium was the same as that which Seaboard paid at about the same time in its purchase of loan contracts from the Barnett Car Co. (I-R 25; Exh. 84, 195; II-R 126

et seq.) and Rapid Thrift Co. (Exh. 78 and 17-Q; I-R 24) In the two latter cases, Seaboard in fact took over the office location of the seller and some of the seller's employees. In addition Seaboard acquired licenses in its own name at these same locations in which the seller had formerly been doing business.

Although Seaboard acquired no place of business, no employees, no license, none of the common attributes of goodwill from U. S. Finance, it paid U. S. Finance and Gulf Finance premiums identical to or higher than that which it paid in the acquisition of the assets of going businesses. This, like the foregoing bits of evidence, corroborates the testimony of Seaboard's witnesses: *that the loan contracts are actually worth a premium,* that this additional value inheres in the loan contract and is not separable from it.

If the Commissioner is to prevail he must succeed where he failed below. He must convince this Court that Seaboard paid for goodwill, not for loan contracts. He must show that Mr. Weidman and Mr. Lide are either incompetent to value small loan contracts or dishonest; that Exhibits 17-Q and 78 are fabrications; that references in the purchase agreements to premiums are a ruse; that the U. S. Finance Co. and Gulf Finance Co. cases are aberrations. We believe that such a finding would be an injustice to the able court below and would do violence to the record presented.

C. The Expenditures In Question May Be Recovered Through Amortization Because They Represent The Cost Of Wasting Assets With Determinable Lives.

The Commissioner in his brief goes to great lengths to classify the premium payments here in question as the cost of purchasing goodwill. His contention apparently is based upon the assumption that once this onerous label is fastened upon these expenditures, the law positively prohibits their recovery through an allowance for exhaustion. This reasoning fails to recognize the reasons for which the regulations and cases prohibit depreciation of the value of goodwill.

Section 1.167(a)-3, quoted at page 3 of this brief, makes clear that the propriety of amortizing the value of intangibles depends upon the ability to prove that such intangibles have a determinable useful life. The section's fiat that "No deduction for depreciation is allowable with respect to goodwill" is simply a statement of the generally-held position that goodwill is so ephemeral, so lacking in substance that its useful life cannot be estimated, and therefore neither the rate nor fact of exhaustion can be determined. As the court said in *Dodge Brothers v. United States,* 118 F.2d. 95, 100 (4th Cir. 1941):

> . . . goodwill is not a deductible item in the computation of a taxpayer's net income. . . . This form of deduction has been denied because of the manifest difficulties inherent in the computation of both the life span and value of this intangible asset.

The Commissioner has not in this appeal contended that the trial court wrongly determined that the value of the payments in question, including that portion if any which was paid for the prospect that the loans would be refinanced, would be exhausted in three or five years.

Thus it may be assumed that he concedes that the useful life of this asset (probability of renewal) was correctly determined by the court. Once the determination is made that an intangible asset is a depreciating one with a determinable life it becomes irrelevant what name is assigned to the asset. "Premium," "cost of purchased contracts," "goodwill" or other such titles are useful only insofar as things generally falling into such classes may be said to have the characteristics of the class.

Seaboard does not for a moment concede that the premium can by any stretch of the imagination be called a payment for goodwill, but even if it were so classifiable, the clearly established value and determinable life of the premium would make it a depreciable asset within the meaning of the Code. Thus in conceding that what he calls the prospect of "continued patronage" will end in three to five years, the Commissioner concedes that it falls in that class of intangibles for which a depreciation deduction is available under Section 167, regardless of the name he chooses to apply to the asset itself.

The Commissioner relies primarily upon dicta from *United Finance and Thrift Corp. of Tulsa v. Commissioner,* 31 T.C. 278, 286 (1958), aff'd 282 F.2nd 919 (4th Cir. 1960); cert. denied 366 U.S. 902, 81 S.Ct. 1045 (1961) for the proposition that the payments here in question represent goodwill. In that case the taxpayer had purchased the assets of a small loan company for a lump sum. A portion of this sum was allocated to a covenant not to compete in the purchase contract. The taxpayer deducted an allowance for exhaustion of the "covenant" on its return, and the Commissioner contended that the entire cost of the covenant was a disguised payment for goodwill. The Tax Court stated the issue in *United Thrift* as follows:

> The primary issue for our consideration is purely a factual one; namely, whether the State Loan Company (Oklahoma) . . . paid a consideration for *covenants not to compete* with their business in a designated area as a distinct and *severable item* at the time it purchased the tangible assets, including certain ledger loan accounts, of two small loan businesses . . . and if so, the amounts to be attributed to such covenants not to compete. (At page 284. Emphasis added.)

Thus, the issue in *United Thrift* was not, as here, what was the value of the purchased loan accounts. The court specifically noted that

> As to the amounts paid for the tangible assets (mainly petty loan accounts) as such, *neither party raises any question* and we have no doubt that those amounts were reasonable and correctly represented in the contracts. (At page 286. Emphasis added.)

It cannot be determined from the opinion whether the price of the purchased loan accounts included a premium on the high quality loans, and thus the case is of no assistance whatsoever in determining the issues properly before this court. The sole question there was the propriety of allocating a portion of the consideration to covenants not to compete.

The Commissioner relies heavily upon the court's passing remark that the prospect of renewal financing by loan contract borrowers was "the significant factor in connection with goodwill." This reliance gives weight to a portion of the opinion which it cannot be given. No evidence was produced on the question as to whether the prospect of renewal was a characteristic of loan contracts whether purchased singly, in bundles, or as part of an acquisition of a loan company. The court did not go beyond noting

that there was present a prospect of continued patronage, and remarked gratuitously that this might be considered goodwill.

The court in *United Finance* was under no necessity of deciding what the amounts *not* paid for the seller's promise not to compete were paid for. In the absence of clear and convincing proof to the contrary by the taxpayer the court was required to sustain the Commissioner's contention that the payments were for goodwill. (Rule 32, Tax Court Rules of Practice) The court attributed more than half the amounts in question to the covenants not to compete and denied a deduction as to the remainder.

What the court might have held if the taxpayer had offered proof that the payments were made as a premium on loan accounts is not worth our speculation. The fact that it did not decide the question is sufficient to establish that the case is no authority for deciding *this* case.

It is worth noting that the Commissioner relies so heavily on the *United Thrift* case for a point which was not before the court, and for which, therefore, the case is not authority, yet distinguishes the case of *North American Loan and Thrift Co. No. 2 v. Commissioner,* 39 T.C. 318 (1962), affirmed 319 F.2d 132 (4th Cir. 1963). The court in that case, says the Commissioner, did not decide the question of the propriety of amortizing a premium paid on small loan accounts, and therefore its apparent concession that the loan accounts were worth a premium is not authority for that proposition. It is difficult to see why the court's implication that loan renewals may be goodwill in *United Thrift,* where the court did not even consider the value of the contracts themselves, is authority for the Commissioner's case whereas *North American Loan,* a case in which proof of the value of such contracts was primary, is not authority on this subject.

Seaboard concedes that neither case is a direct holding on the question of the value and classification of loan contracts and their prospective renewal features. However, if weight is to be given to either case, *North American Thrift* is the only such case in which the issue here involved was in any way considered by the court.

In *North American Thrift,* there is nothing to indicate that, as here, the buyer of a small loan company actually spread the accounts and valued them separately in arriving at the purchase price. Nevertheless the buyer did pay an amount in excess of the book value of the assets and deducted on its return for the year in question an allowance for exhaustion of a part of this amount as "amortized premium on loans purchased." The petitioner proved at trial that the purchased loans (all one year loans with terms remaining of less than one year) would have a life of fourteen months due to renewals, and the court so found.

The court noted that "the evidence tends to support petitioner's original position on its books of account and on its return for 1952 that the amount capitalized was in fact paid as a premium for the 611 loan accounts acquired from Georgia Finance . . . " The petitioner, however, did not prevail because the 14 month life of the accounts had expired before the year in which the deductions were taken. The court was, however, for purposes of decision willing to assume that such premiums are amortizable.

It should be noted that the Commissioner in this appeal concedes that premium payments are amortizable since he does not here contend that the Tax Court erred in so determining. He is solely contending that the Tax Court erred in determining that the amounts in question were in fact premiums rather than payments for goodwill.

Since he is willing to concede the Tax Court's assumption in *North American Thrift*, the Commissioners' attempt to distinguish that case falls flat. The Court indicates clearly that if it reached that point it would make the finding that the amounts in question were paid as premiums on the loan accounts. Once this is decided the Commissioner must concede that such amounts were amortizable.

Seaboard's case is much stronger than that in *North American Thrift*. Seaboard has introduced clear and convincing proof that the loan contracts purchased were worth a premium, that it separately valued and ascertained the amount of such premium, and that it in fact paid a premium for the contracts. In addition, Seaboard proved the life of the contracts and the court so found. Seaboard amortized such premiums over the useful life of the contracts and took deductions for exhaustion in the appropriate years. On the basis of such proof and the total absence of proof to the contrary, the holding below must be sustained. The premiums were paid for wasting assets with ascertainable lives, and, therefore, the cost may be recovered through amortization.

The tax law has long recognized that mortgages, bonds, notes, and other commercial paper representing loans at interest may at times command a premium in the market place. This happens so frequently with the trading of corporate bonds that there is a specific section (§ 171) dealing with premium amortization. It is obvious that buyers would be paying tax on a portion of their purchase costs, as well as on their profit if they were forced to treat premium as an unamortizable capital expenditure, rather than deducting it from income.

The Commissioner himself recognizes this fact as is clearly demonstrated in Revenue Ruling 258, 1953-2

C.B. 143. There the Commissioner holds that where certain insurance companies purchased F.H.A. insured mortgages "from the original lenders at a 'premium' (*i.e.,* at a price in excess of the principal amount of the mortgage notes)" such premiums could be amortized over the remaining life of the mortgage contracts.

Surely this rule would not vary if an insurance company purchased all, rather than some, of a lender's mortgages. If in fact a premium is paid for a mortgage it should make no difference whether the mortgage was purchased singly or as part of an asset acquisition.

The loan contracts in this case are simply a species of commercial paper representing bona fide loans at interest. Because of their high interest rate and other characteristics they can command a premium. Seaboard paid premiums for the loan contracts acquired herein, and like other purchasers of securities at a premium. Seaboard should be permitted to recover this cost in computing its income from such investments.

D. The Prospect Of Refinancing Is Simply A Valuable Right Accompanying A Loan Contract. Unlike Goodwill, It is Not Associated With The Continued Existence Of Any Business.

The Commissioner asserts that the payments in question must have been for goodwill because they obtained for Seaboard the probability of refinancing, which, he says, is equivalent to continued patronage, which, he says, is always goodwill. To sustain this line of reasoning, the Commissioner contends that the fact that customers will return is conclusive proof of goodwill, regardless of the circumstances effecting their return.

It should be noted here that the Commissioner is mistaken in his assumption that the sole reason for the payment of premiums on the loan contracts was "because those were the accounts that would be refinanced and remain on the books for a longer period than the term remaining when purchased." (Comm'r's Brief at page 16) Seaboard concedes that the probability of refinancing contributed significantly to the value of these contracts. Nevertheless, because of the high interest rate and quality borrowers, such contracts would be worth a considerable premium even if the borrower did not refinance. It is not necessary to use mathematics to see that the rate of return is much higher than that yielded by most investments.

Refinancing was only one of the factors contributing to value. The testimony at trial, particularly that of Mr. Weidman, established that the factors which made the contracts worth a premium were, among others: (1) the effective interest rate of the particular contract, (2) the probability that the contract would be paid promptly and in full, (3) the period of time over which refinancing could be anticipated, and (4) probable collection expense. The Commissioner does not, however, argue that any of the evaluation factors other than the prospect of refinancing are indicia of goodwill.

The Commissioner's position that wherever there is a probability of repeat business in a transfer of assets there is a sale of goodwill is based upon a phrase taken from the opinion of this court in *Boe v. Commissioner,* 307 F.2d 339, 343 (9th Cir. 1961). This was the court's generalization of a complex idea as follows: "To us, the essence of goodwill is the expectance of continued patronage, for whatever reason." Taken by itself, this statement would suggest that when one buys any supply or

manufacturing contract he has purchased goodwill since during the life of the contract he will continue to have customers. Unfortunately the Commissioner, like all who apply general statements without regard for the underlying reasoning, has extended the scope of this statement to an area which it does not cover. Counsel is certain that this court did not mean to suggest that every means by which repeat custom may be obtained is goodwill.

The definition of goodwill quoted at page 19, *supra*, from *Metropolitan National Bank of New York v. St. Louis Post Dispatch*, clearly states the Supreme Court's view that goodwill is the worth of a business which exceeds the value of its assets, and that it is primarily a predilection on the part of customers freely to return and patronize the business for reasons which seem sufficient to them, even from prejudice. This definition has been quoted in many cases, a few of the most recent of which are *Barron v. Commissioner*, 334 F.2d 58, 61 (5th Cir. 1964); *Noerr Motor Freight Inc. v. Eastern R.R. Presidents Conference*, 155 F.Supp. 768, 810 (E.D.Pa. 1957); and *Estate of Masquelette v. Commissioner*, 239 F.2d 322, 325-26 (5th Cir. 1956).

That goodwill is not a compulsory contract right is clearly implied by the court in *Van Iderstine Co. v. Commissioner*, 261 F.2d 211, 213 (2nd Cir. 1958):

> The "goodwill" that is the subject of purchase and sale always involves the relations of the seller with third persons .... Such relations *have no existence apart from the feelings, habits, and desires of these third parties.* (Emphasis added)

From this one must reason that if the third parties are compelled by contract or other considerations wholly apart from their "feelings, habits and desires" to resort to a particular business, their custom is not goodwill.

Where a seller has a power to compel buyers to patronize him whether they wish to do so or not he does not need nor possess goodwill.

The court in *Dodge Brothers v. United States, supra,* at page 100 says:

> Goodwill cannot be carved out of a business and sold independently of the going concern; for its tangibility and its value exist only to the extent that such tangibility and such value are connected with a going business.

Thus, a patronage which can be sold piecemeal, while the owner remains in business at his old location with his same name and same business, cannot be goodwill. The customers are transferred whether they will or no, even if they prefer to deal with the old business. If a customer is bound by contract to patronize a business and that contract is transferable, his patronage may be sold, but this is the sale of a contract right and not of goodwill.

The small loan contracts which Seaboard purchased bound the borrowers to repay a fixed sum over a definite period. This they must do for a transferee even though they might have preferred to continue to do business with the transferor. When these persons needed additional funds they were faced with two choices, incur a new debt or refinance the old. If they incurred a new debt they would be paying a higher interest rate than if they refinanced because a greater portion of their total debt would fall in the lower ranges where state laws allow higher interest rates. In addition, in applying for the new loan they would have to list the old loan among their debts which would restrict their ability to borrow elsewhere. Thus it is clear that the borrower under a small loan contract is, to use the vernacular, "hooked." Until the loan is paid he will be most likely to patronize

the owner of his contract regardless of whether the original lender remains in business or whether he prefers to deal elsewhere.

This is the significance of the fact that Seaboard paid premiums for the loan contracts of U. S. Finance Co. and Gulf Finance Co. Mt. Rainier. Seaboard knew that among the things which made such contracts valuable was the fact that the obligors would refinance them with the owner on an average of two to three times. Seaboard also knew that this would occur despite the fact that the original lender remained in business and the borrower probably preferred doing business with the original lender. Since the customer was transferred apart from the business, by definition goodwill was not involved. The fact is that sale of the loan contracts, not transfer of goodwill, brought the customers to Seaboard for a period of three to five years.

In *Merchant's Acceptance Company v. Commissioner,* 23 CCH Tax Ct. Mem. 896, P-H Tax Ct. Mem. ¶64,149, the Commissioner, as seems frequently to happen, was arguing precisely the opposite proposition which he is urging before this Court. In that case the petitioner was a loan company which had acquired and held in the ordinary course of business a large number of small loan contracts. The petitioner sold its prime notes and office furniture to "a large commercial finance company." The buyer paid a premium above the principal balances outstanding for these notes.

The seller argued that the entire amount of the premium was capital gain because it was not specifically excluded from capital gains treatment by section 1221. In the alternative the seller argued that a part of the premium was paid for goodwill and thus taxable only at capital gain rates. The Commissioner successfully argued that assets were a part of inventory and gain there-

on was ordinary income. Furthermore, the premium was not paid for goodwill *because it was entirely attributable to the sales price of the loan contracts.*

Now that the Commissioner has eaten his cake in the *Merchant's Acceptance* case he seeks to have it in this case. It is perfectly obvious that if there is any tax avoidance here it is on the part of the sellers who transferred their loan contracts to Seaboard. The gain on the sale was income to them in lieu of the interest they would have collected had they retained the contracts. But to Seaboard the premiums represent a cost which it is entitled to recover before computing its income on the transactions.

Since Seaboard has no knowledge to the contrary, it presumes that the sellers paid tax on the premiums as ordinary income. Now the Commissioner seeks a double tax by forcing Seaboard to take a portion of the purchase price of the loan contracts into income.

The Commissioner makes much in his brief of the fact that by purchasing the loan contracts here in question Seaboard avoided the initial losses which are usually experienced in opening new offices. This, he says, is proof of the existence of goodwill because a profitable patronage was immediately obtained. This argument ignores the fact that all "startup" costs would have been deductible as business expenses when incurred and recoverable as loss carryovers against future profits when the office became profitable. Thus, the very expenses he admits Seaboard avoided would have been recoverable by appropriate tax treatment. Yet, the Commissioner contends that the cost of avoiding these deductible expenses is not deductible.

The businesses from whom Seaboard purchased loans had spent money for advertising, overhead, credit reporting, and other costs in obtaining these loans. *The actual cost to the seller of these loans exceeded the face amount.* Therefore, to a buyer who need incur no selling expense to obtain the loans, they were worth a premium. In effect Seaboard paid its startup costs as a premium rather than as salaries, rent, advertising expense, etc. It should be allowed to amortize such costs to provide the equivalent deduction. Only if the price paid exceeded the true value of the loans (including their prospective renewal feature) should any goodwill be found present.

Nothing in the tax law prevents a supplier from buying at a premium contracts of another to keep his business operating at a profit. Only if he cannot prove the value and life of the contract can he lose his right to amortize. Seaboard has amply demonstrated that no part of the purchase price of the contracts can be attributed to goodwill. Seaboard paid the value of the contracts and has proved they have a definitely ascertainable life.

E. The Loan Contracts Purchased By Seaboard Were Individually Examined, Valued, And Purchased. Seaboard Paid Nothing For The Existing Customer Structure Of A Business.

At page 20 of his brief, the Commissioner introduces his contention that this case is appropriate for the application of the so-called "indivisible asset" rule. He cites as authorities a large number of cases in which it was held that the taxpayers failed to prove either the cost of specific contracts for which amortization was claimed or the life of such contracts, or both. In most of these cases the courts found that the taxpayers had failed to sustain their burden of establishing that they had paid a specific

consideration for the contracts in question. Upon the failure of such proof, the courts, being unable to determine any separately identifiable amount to amortize, denied the deduction. The cost of the assets was "indivisible" from the general purchase price. These cases involved situations just the opposite of that here. Here specific cost and life have been specifically proved, taking the loan contracts outside the indivisible assets rule.

It would not be practical to analyze and demonstrate the inapplicability of each of the cases cited by the Commissioner at pages 20 and 21 of his brief. Three of these cases are particularly important in the development of the "indivisible asset" rule. The rest turn almost solely on failure of proof. These three are *U. S. Industrial Alcohol Co. v. Commissioner,* 42 B.T.A. 1323 (1940) aff'd 137 Fed. 511 (2nd Cir. 1943); *Thrifticheck Service Corp. v. Commissioner,* 33 T.C. 1038, aff'd 287 F.2d 1 (2nd Cir. 1961) and *Boe v. Commissioner,* 35 T.C. 720 (1961), aff'd 307 F.2d 339 (9th Cir. 1962). We will comment briefly on each of these.

The opinion in each of the three cases is carefully drawn to insure that the "indivisible asset" rule is not used where it does not apply. The first and most important limitation upon the rule is stated in *Thrifticheck,* wherein the Tax Court specifically distinguished the situation there involved from that in which the taxpayer buys contracts with a determinable life calling for a fixed payment:

> It should be pointed out that the purchase here in question *is not similar to the purchase of a contract or contracts calling for the payment of the determinable amount of income over an ascertainable period.* There was no minimum of service which each bank undertook to receive and pay for. The amount of

> income which would result from any individual contract would depend upon the number of customers of the bank who might elect to use the Thrifticheck system. P. 1047. (Emphasis added)

Similarly the Tax Court in *U. S. Industrial Alcohol Co., supra,* points out that the "contracts" purchased were, as a practical matter, unfilled orders; they were not binding contracts which "contributed in any substantial degree to the value of the business.":

> We conclude that under the present facts the significance of the contracts lies not in whether or not they were legally enforceable, but in whether petitioner can be regarded as having acquired them with any idea that they would be enforced, or *that their enforceability, if any, had value for it, or that this quality contributed in any substantial degree to the value of the business for which the purchase price was paid, so that any significant sum could be attributed to it.* Under the circumstances stated, bearing in mind particularly that the prices fixed in the sales contracts were concededly at or below market, we are unable to come to the latter conclusion; but, on the contrary, are satisfied that the participation of the contracts in the present transaction was noteworthy in the same way as was apparently recognized generally in the industry; that is, that, for the purpose of determining their cost and relationship to Kentucky's business and petitioner's purchase of it, they are to be treated as of no different consequence than unfilled customer's orders in other lines of business. pp. 1344-5. (Emphasis added)

These two cases, two of the most important in the development of the doctrine, circumscribe the rule and find it to be inapplicable to assets which are binding

agreements to pay money or render other valuable services. In short, they limit the doctrine to a *class of assets* like customer lists and to contracts which in practical effect are like customer lists.

Seaboard's purchased loans are not within the class of asset to which the doctrine is limited in the passages quoted above. Seaboard purchased contracts calling for a "determinable amount of income" over an "ascertainable period." It did not purchase "unfilled customer's orders." A loan contract is the antithesis of an unfilled order or an unenforceable contract. Unquestionably the contracts had "substantial . . . value;" the Commissioner admits as much. They are not within that class of asset which the court in *Thrifticheck* so carefully circumscribes.

That the doctrine does not apply to contracts and similar intangible assets which have identifiable and real value apart from goodwill is substantiated by two recent Tax Court decisions. In *North American Service Co.*, 33 T.C. 677 (1960), the taxpayer was permitted to amortize the cost of a large group of contracts with its customers. In *Savings Assurance Agency, Inc.*, P-H Tax Ct. Mem. ¶63,052; 22 CCH Tax Ct. Mem. 200, deduction, through amortization, of the cost of an insurance agent's customer list was permitted. In the latter case the court distinguished the *Boe, Thrifticheck,* and *U. S. Industrial Alcohol* cases, finding that the customer list had substantial value entirely apart from goodwill because of the circumstances of the case. In the former case the contracts had value because the seller had incurred most of the expense, but had received only part of the income, attributable to the contracts. The loan contracts here involved have a more substantial and apparent value than did the intangibles in either of the two cited cases. In this case the sellers had run the credit check; loaned the money; and

had sold to Seaboard contracts which were ripe for harvest with little additional expense.

A second exception to the "indivisible asset" doctrine is indicated by the following language in the *Boe* case:

> Petitioner has shown us *nothing to indicate that the contracts here in issue were not a collective, single asset.* In fact, the record is most persuasive that they were. We note, *inter alia,* that the 1947 sales agreement identified its subject matter as "the contract medical practice"; it provided an option for termination in vendor if the "membership" (the original 8,984 contracts *plus contracts thereafter acquired*) fell below 50 per cent of the membership transferred, and it refers to this right as an "option to re-acquire and repossess the said practice." The sales agreement *nowhere attempts to value individual contracts or treat them as separate units* and in its attached "Exhibit C" it provides for dissolution payments to members of vendee partnership based, not upon number of contracts, but upon "an amount equal to the share of the net income of the business for the year of such [event of dissolution] and for each of the two fiscal years next thereafter ensuing." p. 725. (Emphasis except that in parenthesis added)

Here the court suggests that if the taxpayer can show that his price was actually based upon the value of the contracts in question and that he made an effort to value them individually, then the doctrine will not bar a depreciation deduction.

This exception fits Seaboard's case as perfectly as does the "asset" exception. In every purchase Seaboard placed a value on the specific loan contracts in each office.

Other evidence in the record demonstrates that Seaboard was interested in individual loan contracts and

valued them individually. First, there are the schedules attached to Exhibits 8-H, 15-O, 17-Q, 19-S, 20-T, and 57-EE which were stipulated to be representative of those attached to almost all the other contracts. [Stip. 7] These list each contract by number, borrower's name and balance. Second, there are the summaries reflected in Exhibits 78, 79 and 84.

In *Boe* the court said: "Petitioner has shown us nothing to indicate that the contracts here in issue were not a collective, single asset." Here Seaboard has presented every possible kind of evidence to the effect that small loan contracts are not fungible; that Seaboard typically placed a specific value on every purchased contract; that it did so in the purchases here involved; and that two loan contracts which to a layman may look alike may in fact differ in value to the sophisticated buyer by a wide margin. We submit, therefore, that Seaboard fits within a second exception to the indivisible asset rule in that it did in fact value and purchase the contracts individually insofar as that was possible.

The Commissioner's acts, in contradiction to his words; acknowledge that the present case is quite unlike *Boe, Thrifticheck,* and *U. S. Industrial Alcohol.* In those cases the taxpayers were required to capitalize the costs of the intangibles involved; in none was the taxpayer permitted to recover his costs by depreciation or by exclusion from income. Presumably those taxpayers would be permitted to recover their costs only upon the sale or other disposition of the intangibles involved. The cost in each case was treated like an investment in land or in some other non-depreciable tangible asset.

The Commissioner's position here departs from his position in those cases. Here the Commissioner has not questioned Seaboard's right to recover free of tax an

amount equal to the principal balance of the purchased contracts. This departure can best be analyzed by reference to the hypothetical example given by Mr. Weidman. (II-R 213) He assumed a typical situation in which Seaboard pays $315 for three loan contracts. One it values at $90; one at $100; and one at $125. For accounting convenience $300 would be charged to "accounts receivable" and $15 to the "premium" account. That part of the cost charged to "accounts receivable" would be recovered without payment of tax simply by excluding that amount from income as it was received from the borrowers. The premium would be amortized and deducted. Although the Commissioner is aware of this process, he has not questioned the tax-free recovery of the $300; he has questioned only the amortization deduction.

The indivisible asset doctrine *assumes* that the premium is but a part of the cost of the loan contract. If these contracts together constitute one mass asset which flucuates but does not decrease in value, how can Seaboard be permitted to recover $300 of its cost tax free? What ground is there for distinction between two parts of the cost of one asset? If the asset is not wasting, Seaboard is entitled to recover none of its cost by deduction or exclusion; if the asset is depreciating Seaboard is entitled to recover its entire cost over the asset's life.

In *Boe, U. S. Industrial Alcohol Co.,* and *Thrifticheck* the Commissioner's acts were consistent with his theory; in those cases the taxpayer recovered none of its cost by depreciation or exclusion from income. Here the Commissioner's allowance of the tax-free recovery of most of the cost betrays his disbelief in his own argument. This inconsistency in the Commissioner's position is further persuasive evidence that the indivisible asset rule does not apply to debt obligations such as those here involved.

Finally, the rationale and purpose of the so-called indivisible asset doctrine negates its application in this case. When a taxpayer purchases a business consisting of a variety of tangible and intangible assets he frequently pays more than the book value of the assets. The taxpayer may be motivated to value the depreciable assets at the highest possible figure and to allocate what is in fact a payment for goodwill to some asset such as a customer list so that he can at least attempt to recover that amount by depreciation.

This type of tax-avoidance was likely involved in *U. S. Industrial Alcohol Co.* where a large value was assigned to contracts for the right to sell at less than market price, a right whose value is questionable at best. The *Boe* and *Thrifticheck* cases involve similar attempts to infuse some value into assets which had no existence independent of goodwill and no value whatsoever except as an integral part of the business. In each of these cases the indivisible asset doctrine provided a useful tool to strike down a depreciation deduction for an amount which should properly have been allocated to goodwill.

That the doctrine does not and cannot apply to certain assets is indisputable. Where the asset acquired has an independent and substantial value, the rationale and purpose of the doctrine would be thwarted by its application. A taxicab company would not be denied a depreciation deduction on its taxicabs under the mass asset theory simply because it started business by acquiring another company's taxicabs *en masse* and because the total number of taxicabs thereafter remained relatively constant. Yet unless this rationale and purpose place some limits upon the doctrine's application, it would necessarily extend to the taxicab situation as an "indivisible mass asset" purchase.

The present case does not involve tax-avoidance of the kind the rule was designed to prevent. It cannot be disputed that the debt obligations here purchased, like the taxicabs, had substantial value entirely apart from a going business. Both the oral and the documentary evidence presented by Seaboard show that Seaboard in fact valued the loan contracts in the manner indicated in the taxicab example discussed above. The summary sheets which are in the record as Exhibits 78, 79 and 84 show explicitly that the purchased contracts were valued at more than the principal amounts owing on them. Those sheets were prepared by persons with the limited responsibility of evaluating the assets to be purchased. It was not their responsibility to consider income tax consequences.

In short, the value here contended for is a true value; it is not one invented to insure a greater depreciation deduction than Seaboard deserves. For that reason, the rationale of the indivisible asset doctrine prevents its application here. Seaboard falls within the two exceptions carefully carved out in *Thrifticheck* and *Boe;* it did not purchase assets of the proscribed class, and it individually evaluated the contracts.

CONCLUSION

Seaboard has shown in its brief that the Commissioner is here seeking to set aside findings of fact by the court below. These findings are amply supported by all the evidence introduced at trial, and cannot therefore be set aside as clearly erroneous. Furthermore, the authorities, both those cited by Seaboard and those cited by the Commissioner, lend support to the proposition that the disputed payments were a part of the purchase price of loan contracts and are amortizable just as are premiums paid in purchasing any type of interest-bearing security. For these reasons Seaboard respectfully requests that this court affirm the holding of the learned judge below.

Respectfully submitted,

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Attorneys for Respondents and Cross Petitioners

III SEABOARD'S CROSS APPEAL

Specification of Error

The Tax Court erred in failing to hold that 100 per cent of the amounts in dispute was attributable to the loan accounts and therefore could be amortized and deducted from Seaboard's income.

ARGUMENT

A. The Evidence Proves That Not 70 Per Cent, But 100 Per Cent Of The Amounts In Question Is Attributable To The Loan Contracts.

Seaboard does not here wish to argue that under the circumstances of this case this court may set aside the finding of the Tax Court that 70 per cent of the premium was an amortizable cost of acquiring loan contracts and 30 per cent was attributable to goodwill. Seaboard is convinced that, as it argues in part A of its argument in response to the Commissioner's brief above, the findings of the Tax Court are factual and sufficiently supported by the evidence that they may not be set aside as clearly erroneous. However, should this Court conclude that it may properly redetermine such findings, Seaboard submits that the evidence overwhelmingly demonstrates that not 70 per cent but 100 per cent of the premium was attributable to the loan contracts.

Seaboard does not wish to extend its brief unnecessarily by repeating here its discussions of the evidence appearing in the preceding sections. We will content ourselves with a brief review of these items:

(1) The loan contracts were worth a premium because:

(a) They carried relatively high rates of interest;

(b) Extensive information on the borrower's payment record and general financial background demonstrated the quality of the loans;

(c) A purchaser would be spared the expenses of overhead, advertising and credit check, which it would have to pay in writing new loans;

(d) The contracts carried with them the prospect of refinancing.

(2) Seaboard examined the loan contracts individually and determined their value.

(3) The loan contracts were worth a premium whether purchased singly or in conjunction with the assets of a loan office.

(4) The Commissioner introduced no evidence at trial which tended to prove that the loan contracts were worth less than Seaboard paid for them.

(5) Seaboard did not use the company name of the offices it acquired, it frequently moved the offices rather than staying at the former location, it obtained no employee contracts, it did not buy any licenses, and in general neither bargained for nor obtained any asset of the type usually associated with goodwill.

(6) The contracts had definitely ascertainable useful lives of three years and five years.

In the face of such evidence, the allocation of 30 percent of premiums paid to goodwill must be considered arbitrary. There is nothing in the record to suggest that

Seaboard obtained any goodwill, or indeed that any seller possessed goodwill. In the absence of proof to the contrary or a convincing refutation of Seaboard's evidence by cross examination, the facts established by Seaboard must be deemed admitted. Seaboard did in fact pay a premium to purchase loan contracts. This premium is deductible in full when amortized over its useful life.

B. The Sellers Did Not Possess Goodwill, And Therefore No Part Of The Premium Could Be Attributable To Goodwill.

The evaluation of goodwill has been a continuing source of dispute between the Commissioner and taxpayers through the years. It is an asset hard to define, harder to value. In response to this evaluation difficulty the Internal Revenue Service has put forward a formula, ARM 34, 1920-1 C.B. 31, to be used in cases such as the present one.

The formula has been used as the basis for decision or has been urged on behalf of at least one party or the other in at least 58 cases. The Commissioner has consistently used the formula to prove the presence of goodwill in a purchased business when it suited his needs, extending to the very recent past. See *e.g., American Steel & Pump Corp.,* P-H Tax Ct. Mem. ¶ 62,024, 21 CCH Tax Ct. Mem. 109.

The history of the formula, traced in the many cases in which it has been cited, shows that it has been applied to businesses all across the commercial spectrum. It has been used in such industries as the manufacturing of door hinges, the selling of windows, the feed and seed business, and the operation of a newspaper.

The formula rests upon the thesis that the earnings of a business are the touchstone of goodwill. It assumes

that the earnings will show the effect of the other factors commonly associated with goodwill such as location, name, and personnel. That this earnings thesis is in accord with the present thinking of the Commissioner is shown by the following excerpt from a 1959 Revenue Ruling:

> In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. Rev. Rul. 59-60, 1959-1 C.B. 237, 241.

The formula establishes the "fair return on . . . net tangible assets" at 8, 9 or 10 per cent. If the formula is applied in the manner set out in ARM 34, it will show no goodwill in any business that returns less than 8 per cent; it will show some goodwill in every business that returns more than 10 per cent. The formula contemplates capitalizing the amount by which the return exceeds 8, 9, or 10 per cent. It specifies the use of the average earnings for the five years immediately preceding the valuation date to arrive at the average return.

Seaboard is able to apply the formula only to National Finance Corporation, Monmouth Loan Corporation, and to the nine subsidiary corporations whose stock was purchased from American National Finance Co. In no other cases does Seaboard have access to corporate records or tax returns of the sellers.

Seaboard believes that the application of the formula to the earnings of the eleven corporations above described produces a result which is representative of all the purchases under consideration. More than one-half of the aggregate premium here in question was paid to acquire the loan contracts of these eleven corporations; the

subsidiaries of American National Finance Co. alone account for approximately one-half of the entire premium. American National Finance Co. operated in states, notably New Jersey, in which the small loan business was relatively most profitable. (II-R 114, *et seq*) Moreover, Seaboard paid as high a premium for the loan contracts purchased from American National Finance Co. as it did in any of the purchases here involved. (I-R 19, Exh. 1-A) It is reasonable to assume that American National Finance Co. would have a higher return than average on its net tangible assets.

Indeed it is likely, though Seaboard cannot prove it, that the earnings of the other sellers prior to Seaboard's acquisitions were lower in relation to net tangible assets than those of the American National Finance Co. subsidiaries.

Seaboard's ARM 34 computation is set forth in Appendix "A". The figures which form the basis of this computation are from the tax returns in evidence as Exhibits 63 through 73.

The average return on net tangible assets for all of the corporations to which Seaboard was able to apply the formula was 5.46 per cent. This percentage is a full two and one-half percentage points less than the minimum 8 per cent return which ARM 34 prescribes. It is little more than half the return of 10 per cent which the courts have frequently chosen as a fair return. See *e.g., General Outdoor Advertising v. Comm'r,* 149 F. Supp. 163 (Ct. Cl. 1957), cert. den. 355 U. S. 891 (1957). It exceeds by only a small margin the return on Savings and Loan Association savings accounts. The formula tells us, therefore, that the eleven corporations to which it can be applied had no goodwill at the time of the purchase by Seaboard.

Seaboard is aware of the substantial shortcomings in the application of any formula to a problem as factual as the present one. It realizes, too, that the courts have frequently turned away from a formula approach when better evidence was available to support a decision. Here Seaboard has presented substantial evidence to support its arguments; it offers the formula only as an additional and corroborating factor to substantiate its principal argument.

Despite the limitations inherent in the use of a formula Seaboard believes that ARM 34 has significant value in the present situation. In the consumer finance industry the "assets" of a business are its loan contracts. The return upon these assets is dependent upon the relation between the cost of money borrowed and the return on money loaned. There are no factors such as accelerated depreciation or destruction of physical assets to distort the earnings of a consumer finance company. The return on investment is a more accurate measure of goodwill in the consumer finance industry than it is in many of the other industries to which the courts have applied the formula.

The formula has additional significance here in that this is not a borderline case. The average return in the present situation is not marginal; it falls far short of the minimum 8 per cent specified in ARM 34. The figures are not ambiguous; they emphatically negate the presence of goodwill.

If, therefore, the selling corporations had no goodwill, it is logically impossible that Seaboard purchased any such asset from them. The formula, so often and so effectively used by the Commissioner, speaks out clearly in Seaboard's favor and furnishes strong support for the

conclusion that Seaboard paid the disputed amounts to purchase small loan contracts, not goodwill.

CONCLUSION

Seaboard properly amortized the entire premium paid on purchased loan accounts, and the holding of the learned trial court must be reversed and remanded with instructions to enter judgment that 100 per cent of the loan contract premiums is deductible as exhaustion of a wasting asset under Section 167 of the Internal Revenue Code.

Respectfully submitted,

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APPENDIX "A"

GOODWILL CALCULATED BY ARM 34 FORMULA WITH ADVANCES FROM PARENT TREATED AS EQUITY

Company Purchased	Average Tangible Net Assets	Average Net Earnings	Return on Tangible Net Assets
Industrial Loan Society, Inc. (New Jersey)	$1,501,058.84	$ 93,799.88	6.25%
National Small Loan Society, Inc. (Virginia)	366,578.36	24,819.04	6.77%
American Loan Society, Inc. (Massachusetts)	419,164.69	21,333.42	5.09%
Mutual Loan Company (New Jersey)	638,470.60	30,576.58	4.79%
Equitable Industrial Loan Society, Inc. (Connecticut)	764,361.39	39,440.79	5.16%
Industrial Loan Society, Inc. (Maryland)	167,236.19	16,407.90	9.81%
National Equitable Loan Society, Inc. (Delaware) (Pennsylvania)	331,849.69	20,483.41	6.17%
Industrial Loan Society, Inc. (Delaware) (Pennsylvania)	1,024,681.84	61,073.46	5.96%
TOTAL Purchased from American National Finance Corporation	5,213,401.60	307,934.48	5.90%
Monmouth Loan Corporation	97,822.63	(1,141.40)	(1.17%)
National Finance Corporation	1,227,382.72	50,353.10	4.10%
TOTAL of All Corporations Purchased	$6,538,606.95	$357,146.18	5.46%

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

AUSTIN H. PECK, JR.

Nos. 20,159-20,174

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

SEABOARD FINANCE COMPANY,
SEABOARD FINANCE COMPANY, TRANSFEREE,
SEABOARD FINANCE COMPANY OF LYNWOOD,
SEABOARD FINANCE COMPANY OF MONTEREY,
SEABOARD FINANCE COMPANY OF NORTHERN CALIFORNIA,
SEABOARD FINANCE COMPANY OF COLORADO SPRINGS,
SEABOARD FINANCE COMPANY OF DENVER, TWO,
SEABOARD FINANCE COMPANY OF DENVER, THREE,
SEABOARD FINANCE COMPANY OF DENVER, FOUR,
SEABOARD FINANCE COMPANY OF DENVER, FIVE,
SEABOARD FINANCE COMPANY OF PUEBLO, TWO,
SEABOARD FINANCE COMPANY OF CONNECTICUT, INC.,
SEABOARD FINANCE COMPANY (IDAHO),
SEABOARD FINANCE COMPANY OF TERRE HAUTE, INC.,
SEABOARD FINANCE COMPANY, INC. (MASSACHUSETTS),
SEABOARD FINANCE COMPANY OF FLINT,

Respondents

SEABOARD FINANCE COMPANY, ET AL.,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

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ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE COMMISSIONER

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I N D E X

CITATIONS

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SEABOARD FINANCE COMPANY, ET AL.,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE COMMISSIONER

OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R. 41-112)[1] are not officially reported.

1/ The record in this case consists of two volumes, designated Volume I and Volume II. References to Volume I will be cited as "I-R." and references to Volume II will be cited as "II-R.".

JURISDICTION

These consolidated petitions for review (I-R. 129-131) and cross petitions for review (I-R. 132-134) involve federal income taxes for fiscal years ending in 1955, 1956, 1957, and 1958.[2/] By his notices mailed to the taxpayers on March 2, 1962 (I-R. 1) the Commissioner determined deficiencies in the aggregate amount of some $621,000 (I-R. 42-43). Within ninety days thereafter and on May 24, 1962, the taxpayers filed petitions for redetermination with the Tax Court, pursuant to Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-5.) The decisions of the Tax Court, redetermining the deficiencies at about $202,000, were entered on December 16, 1964. (I-R. 113-128.) The case is brought to this Court by petitions for review filed by the Commissioner on March 10, 1965 (I-R. 129-131), and by cross petitions for review filed by the taxpayers on April 16, 1965 (I-R. 132-134), all within the time prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of the 1954 Code.

2/ The taxpayers in this case are related corporations. The proceedings were consolidated in the Tax Court (I-R. 41) and are consolidated here (I-R. 143-145). Pursuant to a stipulation of the parties, approved by the Court (I-R. 143-145), the pleadings in Tax Court No. 1756-62 (Court of Appeals No. 20159) are the only pleadings reproduced in the record on appeal and are to be considered representative of the pleadings in the other fifteen proceedings. The term "pleadings" refers to the petition, answer, amended answer, reply to amended answer, petition for review and cross petition for review filed by the parties in each proceeding.

QUESTION PRESENTED

Taxpayers in this case, the Seaboard Finance Company and fourteen of its wholly-owned subsidiaries, are engaged in the small loan business throughout the United States, and during the tax years in issue, they purchased 55 small loan businesses. In each purchase, the outstanding loan accounts were the principal assets acquired and in each purchase the taxpayers paid an amount in excess of the face or book value of the loan accounts.

The question presented is whether the Tax Court erred in holding that 70 percent of the excess purchase price or premium was attributable to the loan accounts (rather than to goodwill) and, as such, was depreciable over the average useful lives of the loan accounts.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION.

(a) General Rule.--There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * *

(26 U.S.C. 1958 ed., Sec. 167.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.167(a)-3 Intangibles.

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset

> may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.
>
> (26 C.F.R., Sec. 1.167(a)-3.)

STATEMENT

Taxpayers in this case are engaged in the business of making small loans throughout the United States, and during the years 1957 and 1958, they underwent a period of rapid growth and expansion. As part of the expansion program, taxpayers purchased 55 small loan businesses and in each purchase, paid an amount in excess of the face or book value of the loans outstanding and the fixed assets acquired, if any. Taxpayers treated the excess purchase price (hereinafter sometimes referred to as the "premium") as part of the cost of the loan accounts and sought to depreciate the premium over the average useful lives of the loan accounts, namely, three years for secured loans and five years for unsecured loans. The Commissioner disallowed the depreciation deductions and proposed deficiencies on the ground that the premium was paid for goodwill, which is not depreciable. The Tax Court found that of the total premium paid, 30 percent was attributable to goodwill, and 70 percent was attributable to the loan accounts. It then held that the premiums allocable to the contracts could be depreciated over the three and five-year periods. The court rejected the

Commissioner's alternative argument that the premium was paid for an existing customer structure with an indeterminate useful life. This appeal followed.

The small loan business is subject to strict controls by the various states because the rate of interest charged by a small loan company is higher than the general usury laws of a state. During the years in issue, the maximum rate of interest that could be charged in California was 2 1/2 percent per month on the first $100, 2 percent on the next $400, and 5/6 of 1 percent on any portion of the balance exceeding $500. This interest amounts to 30 percent annually on the first $100, but the maximum rate varies in the different states. (I-R. 47.)

A small loan company must obtain a license from the state in order to operate an office. Some states issue licenses based upon a test of convenience and necessity which is a determination that the issuance of a license would be to the convenience and advantage of the public. Taxpayers would not buy an office if they could not acquire the seller's small loan license by transfer. (I-R. 47.)

There is competition among various large small loan companies in acquiring smaller loan companies (I-R. 51), and the taxpayers advertise extensively to attract customers. Direct mail advertising is sent to customers and direct mail solicitation is sent to former customers. (I-R. 48.) When a loan is paid down, taxpayers contact their customers with an offer of an "all-in-one" package loan which, in effect, suggests to the customer that he put all of his debts

into one total and borrow the money from the taxpayers to pay off the numerous obligations. (I-R. 49-50.)

A small loan company's new business comes from various sources, but the main source is from present customers. In the taxable year ended September 30, 1957, taxpayers made 553,400 loans, of which 334,051, or approximately 60 percent, were to present customers who refinanced their accounts. In the taxable year ended September 30, 1958, taxpayers made 684,221 loans, of which 414,301 (60 percent) were to present customers by refinancing of existing balances. When an account of a present customer is refinanced, additional money is advanced in 99 percent of the cases, and a customer will generally refinance his loan two or three times before finally paying it off. Of the remaining new business (i.e., 40 percent), approximately 25 percent comes from former borrowers who have previously paid off their loans. (I-R. 49.)

A new small loan office which is started from "scratch", will generally have to operate for about 2 1/2 years before it begins to make a profit. The new office will lose money for a period of time after it begins business and will not reach a break-even point until it has been operating for approximately 18 months. (I-R. 50.) It then takes an additional year or longer before it starts making a profit. The costs incurred by a new small loan office prior to the time it begins to break even in its operations are called start-up costs. When a small loan company that has been in operation for some time is purchased, the buyer avoids the necessity of operating for a period of 18 months or longer

at a loss and avoids incurring the start-up costs necessary to put a new small loan office on a paying basis. (I-R. 51.)

During the taxable years in issue, taxpayers purchased 55 small loan businesses and in each purchase they paid an amount in excess of the face or book value of the loan contracts. (I-R. 50-51.)[3] The value placed on the loan contracts was determined by "spreading" the accounts. (I-R. 52.) The spreading was performed by employees of Seaboard and consisted of listing in columns the number of each loan contract, the name of the borrower, the principal balance due, and a rating or classification of the individual contract. The classification symbols were A+, A, B, C, D and E. (I-R. 52; Ex. 17-Q.)

In classifying the individual contract the person making the spread examined the contract itself and the file relating thereto to determine the qualifications of the borrower. Each contract was then classified as A+, or A, or B, etc., and a total of the balances in each classification was computed. The person spreading the accounts then added to the aggregate balance of the A+ accounts a percentage of the total balance which, in the purchases here involved, ranged generally between 15 and 30 percent. (I-R. 52-53.) No percentage or premium was added to the aggregate principal balance of loan contracts classified as A. The aggregate principal balances of loan contracts in the other classifications (B, C, D, E) were discounted by percentages varying from 25 to 75 percent. (I-R. 54, 56, 64.)

3/ Furniture and fixtures were purchased at book value. (I-R. 51.)

In determining the aggregate value of the loan contracts to be purchased the person making the spread added to the aggregate principal balances owing on all loan contracts the premium on the A+ contracts, and subtracted the discount, if any, on the other contracts. The resulting figure was the amount which was offered for the loan contracts in bargaining with the seller for the loan business. (I-R. 53-54.) In each purchase, taxpayers paid a net premium for the loan contracts. (I-R. 55.) The net premium was entered on the books in a separate account entitled "Premium Paid on Purchased Accounts" (II-R. 213), and depreciated over three and five year periods (I-R. 56-57). The propriety of this depreciation deduction is the basis of the Commissioner's petition for review to this Court.

SPECIFICATION OF ERRORS RELIED UPON

1. The Tax Court erred in failing to hold that the entire premium was attributable to goodwill.

2. The Tax Court erred in holding that 70 percent of the premium was attributable to the loan accounts.

3. In the alternative, the Tax Court erred in failing to hold that in each purchase the premium was paid for the customer structure of a going business which is an indivisible mass asset with an indeterminate useful life.

SUMMARY OF ARGUMENT

The Tax Court's decision, that the taxpayers paid 70 percent of the net premiums for the loan contracts because some of the contracts were worth more than their face value, fails to probe the essential inquiry in this case; namely, why were some contracts worth more than face value while others involved in the same purchase were worth only face value, or less? The answer to that question is fairly obvious. The taxpayers were willing to pay a premium for some of the loan contracts because, on the basis of the taxpayers' analysis of the accounts, those were the loans that were most likely to be renewed or refinanced. On the other hand, loans which would run off the books at the end of the term remaining when purchased were worth only face value to the taxpayers, and those loans which would require collection efforts were discounted.

The taxpayers' prognosis, that the premium accounts would be refinanced, proved to be quite accurate. During the years in question, approximately 60 percent of the taxpayers' business came from present customers who refinanced their accounts, while another 10 percent came from former customers who had previously paid off their loans. Each time an account is refinanced, additional money is advanced to the borrower and the taxpayers earn interest on the new money. To illustrate the importance of refinancing, the taxpayers introduced into evidence two specific loan accounts which were characterized as "typical" accounts for which premiums had been paid. One account, with a principal balance of $190.07 when purchased, was subsequently

refinanced three times and the taxpayers earned $366.16 in interest alone from that account. The second account, with a balance of $303.43 when purchased, was subsequently refinanced five times and returned $403.80 in interest alone to the taxpayers. It was the probability of repeat business, therefore (with its additional income-producing potential) that made some accounts worth more to the taxpayers than other accounts and it was the probability of repeat business that constituted the primary reason <u>why</u> the taxpayers paid the premiums in question. However, as this Court has recognized the expectancy of continued patronage is "the essence of good will" and amounts paid for goodwill are not depreciable.

In addition to the likelihood of repeat business, the premiums were also paid, at least in part, for the benefits of continuity enjoyed by the purchaser of a going business. The main benefit, of course, is the power to earn income over the period immediately after the business is taken over, and this power--insuring as it does against a break in earnings which may be difficult, if not impossible, to reestablish--has a value quite independent of any profit that may be derived from the particular accounts purchased. Moreover, the purchaser of an existing small loan business avoids incurring the start-up costs of a new business and the necessity of operating at a loss for 18 months or more. Finally, the existing customer structure acquired by the purchaser of a going business may, as in the instant case, be solicited for allied services and, as such, constitute yet another source of income. The amount paid for the customer structure of a going business is treated as an investment

in a single indivisible asset with an indeterminate useful life because while the value of a customer structure may fluctuate from time to time as contracts expire or customers go elsewhere and are replaced by new ones, this is regarded not as a process of exhaustion but rather as a process by which a continually existing asset is kept intact.

In short, the taxpayers paid a premium in acquiring the small loan businesses primarily because of the good prospects of repeat business from the existing customers. In addition, the premium may also be viewed as being paid, at least in part, for the benefits of continuity, the avoidance of start-up costs, and for an existing customer structure. All of these factors are elements of goodwill and the Tax Court erred in failing to hold that the entire net premium was attributable to goodwill.

ARGUMENT

THE NET PREMIUM PAID BY THE TAXPAYERS IN ACQUIRING NUMEROUS SMALL LOAN BUSINESSES WAS PAID FOR GOODWILL WHICH IS NOT DEPRECIABLE

The Tax Court erred in allocating 70 percent of the premiums to the loan contracts because it asked itself the wrong question. The court was of the opinion that (I-R. 102), "The crux of these cases is for <u>what</u> did petitioners pay the premiums here in issue." Having asked itself that question, the court then concluded that <u>what</u> the taxpayers paid most of the premium for was the loan contracts. But the court's conclusion begs the question, because it is impossible to ascertain for what the premium was paid unless we know the reason <u>why</u> the premium was paid. In other words, <u>why</u> was one loan account

more valuable to the taxpayers than another loan account? Or to put it another way, <u>why</u> would taxpayers pay $125 for one loan account with a $100 face value while paying only face value or less for another $100 account? The reason why, as we will show, is because the taxpayers expected to realize more than $125 on the premium accounts, and the reason why they expected to make more money on those accounts was because those borrowers would continue to do business with the taxpayers beyond the remaining term of the existing loans; whereas the loans for which only the face value was paid would run off the books at the expiration of their original terms. The likelihood of continued patronage, for which the taxpayers paid a premium, is clearly goodwill and this Court has so stated: "To us, the essence of good will is the expectance of continued patronage, for whatever reason." <u>Boe</u> v. <u>Commissioner</u>, 307 F. 2d 339, 343.[4/] It is the Commissioner's contention that the high quality of existing loans for which the taxpayers paid a premium was attributable primarily to the good prospects that those loans would be refinanced and that additional money would be advanced from which the taxpayers would realize additional income.

4/ The Fifth and Seventh Circuits define goodwill simply as the probability or expectation that "the old customers will resort to the old place." See <u>Commissioner</u> v. <u>Killian</u>, 314 F. 2d 852 (C.A. 5th); <u>Karan</u> v. <u>Commissioner</u>, 319 F. 2d 303 (C.A. 7th).

A. <u>The high quality of the existing loans, for which the taxpayers paid a premium, was attributable primarily to the good prospects of their renewal</u>

Before discussing the uncontradicted evidence, which clearly shows that the premiums were primarily paid for the probability of repeat business, it will be helpful to discuss the Fourth Circuit's decision in <u>United Finance and Thrift Corp. of Tulsa</u> v. <u>Commissioner</u>, 282 F. 2d 919. In that case, the taxpayers purchased two small loan companies and in each of the purchase contracts a separate consideration was allocated to a covenant not to compete. The Tax Court found that part of the premium was paid for the covenants and part for goodwill, and, as to the latter, made the following relevant comment (<u>United Finance & Thrift Corp. of Tulsa</u> v. <u>Commissioner</u>, 31 T.C. 278, 286):

> The significant factor in connection with goodwill is the petitioners' own testimony to the effect that the paper they bought would be turned over on the average 2 1/2 times and would remain on the books of the purchaser for an average period of 30 months. Petitioners' records show that on the basis of experience this prognosis is quite accurate. We think this clearly represents goodwill or going concern value, and is an intangible asset of substantial worth.

The taxpayers petitioned for review of the Tax Court's decision and the Commissioner did not cross-petition. In affirming the Tax Court's holding that part of the premium designated as payment for a covenant was in fact paid for goodwill, the Fourth Circuit summarized some of the facts as follows (p. 922):

> In the Tax Court, the taxpayers admitted that it was their experience in the small loan business that borrowers do not meet their obligations on

> time; that this results in the necessity for "refinancing" by extending another loan over a longer period of time, and that, on the average, a borrower remains on their books with respect to the original amount borrowed for a period of two and one-half years. Taxpayers further admitted that this "refinancing" is profitable, and that its prospect was one of the main reasons why they were willing to pay more than the face amount of the book obligations in order to acquire another loan company's current accounts. * * *

The court then made the following relevant comment (p. 922):

> With a small loan company, its borrowers are its customers. If its business is to continue, relationships and dealings with those customers are essential. Its stock in trade is the sum total of the choses in action which it holds, representing the obligations of its customers to it. When more than the face amount of those choses in action is paid by a purchaser, who expects to continue the small loan business through dealings with those customers, evidence of good-will value can be looked for. That evidence was found here.

The Tax Court's attempt to distinguish <u>United Finance</u> on the grounds that, here, the taxpayers produced evidence to support their contention that "the loan contracts were worth a premium" (I-R. 107), still ignores the essential question of <u>why</u> the loans were worth a premium. The loans were worth a premium in <u>United Finance</u> because of the likelihood of repeat business through refinancing, and that is precisely the situation here.

Thus, like the court in <u>United Finance</u>, the Tax Court in the instant case found that taxpayers' customers will refinance their loans two or three times before finally paying them off, and each time a loan is refinanced, additional money is advanced to the borrower from which the taxpayers earn additional interest. (I-R. 49.)

The importance of refinancing was illustrated by Weidman, Seaboard's president, by discussing two "typical" accounts for which premiums had been paid. (II-R. 141-149.) In one account, the original balance outstanding when purchased was $190.07. Subsequently, the account was refinanced three times for the following amounts: $133.63, $175.63 and $208.42. The account remained on the books for 54 months and taxpayers realized $366.16 in interest alone from that account. (See Ex. 85.) The balance in the second account when purchased was $303.43. The account was subsequently refinanced five times, and remained on the books for 55 months. The interest realized by the taxpayers from that account totalled $403.80. (See Ex. 86.) Viewed in this light, the reason is perfectly obvious why the taxpayers were willing to pay a premium for some accounts, and there is no reason to doubt Weidman's testimony that the possibility of repeat business through refinancing was "very definitely" taken into account in valuing the accounts. (II-R. 140.)

Moreover, like the taxpayers in United Finance, the taxpayers' prognosis in the instant case, that the purchased accounts would be the source of repeat business, also proved to be quite accurate, because during the years in question refinancing accounted for 60 percent of their business. Thus, the Tax Court found (I-R. 49) that in the taxable year ended September 30, 1957, taxpayers made 553,400 loans of which, 334,051 were "from present customers and were refinancing of existing accounts," and in the taxable year ended September 30, 1958, they made 684,221 loans of which 414,301 were to present customers.

In 99 percent of those cases where the loans were refinanced, additional funds were advanced to the customers.

The testimony of Lide, an employee of Seaboard who supervised the spreading in some of the purchases, also shows that the possibility of renewal was the prime consideration in valuing the accounts. Thus, in describing the method used in spreading the accounts, Lide testified that an account was classified as "A" (for which only the face amount was paid) "if we think that we will collect the balance on the account, but with little possibility of renewal." (II-R. 229-230.) And finally, in explaining the factors taken into consideration in valuing an account, Weidman testified as follows (II-R. 89):

> The factors that would dictate that we would pay less than face would involve <u>those accounts that we would not renew</u>, based on sound credit judgment and which, of course, would run off of the books, according to original terms. (Emphasis added.)

In short, the uncontradicted evidence in this case clearly demonstrates that the taxpayers paid a premium on the A+ accounts because those were the accounts that would be refinanced and remain on the books for a longer period than the term remaining when purchased. That is the only rational reason <u>why</u> a premium was paid and there is nothing in the Tax Court's opinion which suggests a different reason. Thus, the court's conclusion that the premium accounts were simply worth more is only half an answer. It is only when the <u>reason</u> for their value is ascertained that it becomes clear that premium value was attributable primarily to the good prospects of their renewal, which is goodwill, and which, as such, is not depreciable. Treasury Regulations on Income Tax (1954 Code), Section 1.167(a)-3, <u>supra</u>.

In holding that only 30 percent of the premium was paid for goodwill, the Tax Court was apparently over-impressed by the fact that the taxpayers did not use the seller's name or continue to employ the seller's personnel. But this is too narrow a view of goodwill. The important consideration is whether the taxpayers expected the customers to refinance and the evidence shows that 60 percent of the customers did refinance. The small loan business is highly competitive and, as Weidman testified, other sources of credit--such as competitors, banks, credit unions and finance companies--were available to the taxpayers' customers. (II-R. 128-129.) The customers chose, instead, to continue doing business with the taxpayers. The reason why customers refinanced is not important; the fact that they did, is important. United Finance and Thrift Corp. of Tulsa v. Commissioner, supra; Boe v. Commissioner, supra.[5/]

5/ The Tax Court's reliance (I-R. 107) on North American Loan & Thrift Co. No. 2 v. Commissioner, 39 T.C. 318, affirmed, 319 F. 2d 132 (C.A. 4th), is misplaced because the Tax Court in that case never passed on the issue here in question. In that case, the taxpayer purchased a small loan company and sought to depreciate the premium paid over a 14-month period. However, since the 14-month period had elapsed prior to the taxable year before the court, Judge Raum disposed of the issue as follows (39 T.C., p. 326):

> Thus, assuming that petitioner was entitled to amortize the total premium paid therefor, petitioner admits it should have done so over their known life of 14 months. * * * [which] had fully expired prior to 1952, the taxable year in issue. (Emphasis added.)

Contrary to the Tax Court's observation in the instant case, therefore, (I-R. 107) the court in North American Loan did not conclude that the premium was amortizable, but rather, for the purpose of disposing of a moot issue, it simply assumed that the premium was amortizable.

Although the premium was paid primarily for the expectancy of repeat business, it is also reasonable to view the premium as being paid, at least in part, for the benefit of continuity enjoyed by the purchaser of a going business. We will discuss this aspect of the case next.

B. The premium was also paid, in part, for the benefit of continuity enjoyed by the purchaser of a going business

If we limit our consideration to a single loan contract, there appear to be two inducements (other than the probability of refinancing) which will lead to its purchase: (1) the contract may have been made at a higher rate of interest than the permissible rate at the time of purchase, or (2) if it was not, it may cost the buyer something in time and money to secure an equivalent contract. The first inducement did not exist in the instant case because it can be fairly inferred that the rate of interest charged on the loans when originally made was the maximum permissible under state law (II-R. 40), and there is no indication that the legal rate at the time of purchase was different from the legal rate when the loan was made. Thus, there would be no inducement for the taxpayers to pay, say, $115 in order to collect $130, if they could collect $130 by loaning $100 themselves. However, as to the second inducement, Weidman testified that the cost of getting the first loan in a new office is "astronomical" (II-R. 209), and the Tax Court found (I-R. 50-51) that a new office which begins from "scratch" usually operates for a period of 18 months before it breaks even and for another year beyond that before it begins making a profit. However, a buyer of a small loan business

that has been operating for some time avoids the necessity of operating at a loss for 18 months or longer and also avoids the start-up costs necessary to put a small loan office on a paying basis. (I-R. 51.) Thus, the benefit of continuity enjoyed by the purchaser of a going business has a value quite apart from any profit that may be earned from the particular contracts purchased. This proposition was articulated by Judge Hand in United States Industrial Alcohol Co. v. Helvering, 137 F. 2d 511, 513-514 (C.A. 2d):

> In such an industry--for that matter, in any industry--continuity of sales is a condition of continued existence; once they stop, it is extremely hard, if not impossible, to start up the business again. Therefore the power to sell over the period immediately after the business is taken over, insuring as it does against such a break, has a value quite independent of any profit that may be got from those particular sales. There is no reason to suppose in the case at bar that the taxpayer would have paid anything whatever for the contracts if they had not contributed in this way to the continued existence of the business. * * *

In addition to the benefit of continuity and the avoidance of start-up costs, the taxpayers also acquired a customer structure which could be solicited for allied services. For example, customers acquired by taxpayers were sold or solicited for credit life insurance (I-R. 45-46; II-R. 176) and for the taxpayers' "ever-ready chek" program (I-R. 105). Taxpayers also contacted their customers with the offer of an "all-in-one" package loan (I-R. 49-50) and letters were sent to newly acquired customers encouraging them to drop into one of the taxpayers' offices and borrow more money (II-R. 104-106, 176, see Exs. 81, 82, and 83). Finally, over 10 percent of the taxpayers'

new business during the years in issue came from former customers who had previously paid off their loans. (I-R. 49; II-R. 176.)

In sum, the premium paid by the taxpayers in acquiring the various loan businesses is attributable to the good prospects of repeat business; the benefits of continuity, the avoidance of start-up costs and a customer structure to solicit for allied services. All of these factors are elements of goodwill and the Tax Court erred in failing to hold that the entire amount of the net premiums was attributable to goodwill.

C. The premium paid by the taxpayers may also be viewed as the cost of acquiring the sales or customer structure of a going business which is a single indivisible asset with an indeterminate useful life

In being able to step into the seller's shoes, the buyer of a going business enjoys an advantage he would not ordinarily enjoy if he were to start the business from scratch. This advantage is the existence of a sales or customer structure which enables the buyer to realize income as soon as the business is taken over. United States Industrial Alcohol Co. v. Helvering, supra, pp. 513-514. Because a customer structure is such an essential part of any business, a buyer will ordinarily be willing to pay something for it, and when he does, the amount is treated as payment for a single indivisible asset with an indeterminate useful life. See Thrifticheck Service Corp. v. Commissioner, 287 F. 2d 1 (C.A. 2d) (service and supply contracts); United States Industrial Alcohol Co. v. Helvering, supra (supply contracts); Westinghouse Broadcasting Co. v. Commissioner, 36 T.C. 912, 923, affirmed on another issue, 309 F. 2d 279 (C.A. 3d)

(advertising contracts); Anchor Cleaning Service, Inc. v. Commissioner, 22 T.C. 1029 (janitorial service accounts); Boe v. Commissioner, supra (medical service contracts); Danco Products, Inc. v. Commissioner, decided March 14, 1962 (P-H Memo T.C., par. 62,052) (janitorial service contracts); Scalish v. Commissioner, decided March 6, 1962 (P-H Memo T.C., par. 62,046) (location leases for cigarette machines); LaRue v. Commissioner, 37 T.C. 39 (dental practice); Commissioner v. Killian, supra (insurance business); Masquelette's Estate v. Commissioner, 239 F. 2d 322 (C.A. 5th) (accounting business); National Weeklies v. Commissioner, 137 F. 2d 39 (C.A. 8th) (magazine subscription list).

The customer structure is treated as an asset with an indeterminate useful life (and hence, not depreciable) because while its value may fluctuate from time to time as contracts expire and customers go elsewhere and are replaced by new ones, this is regarded not as a process of exhaustion, but rather as a process by which a continually existing asset is kept intact. See, e.g., Scalish v. Commissioner, supra. The taxpayers' own experience illustrates this principle. See Exhibit 77-KKK which shows that the customer structures purchased by the taxpayers have remained substantially unchanged from the date of their purchase through September 30, 1959.

The Tax Court's attempt (I-R. 109-111) to distinguish some of the above-cited cases on the ground that the taxpayers in the instant case made an effort to value the contracts individually is without merit. First, because this did not make each contract a separate asset but

was "merely a formula for determining the total purchase price to be paid." Anchor Cleaning Service, Inc. v. Commissioner, supra, p. 1035. Secondly, the fact that the taxpayers chose to amortize the premium over three or five-year periods instead of pro-rata for each contract, indicates that the taxpayers considered the contracts to be a single asset (Scalish v. Commissioner, supra) and, in fact, Weidman testified that it was not possible to allocate the premium among the individual loan contracts. (II-R. 201.) Finally, the gross premium arrived at by multiplying the sum total of the A+ accounts by a fixed percentage was reduced by the total discounts on the B, C, D and E categories, and the resulting net premium was, as the Tax Court noted, only "one factor used in determining the amount to be offered to the seller" in negotiating for a purchase price. (I-R. 54.) In other words, the premium finally arrived at in each purchase was a negotiated lump sum, and it was not and it could not be broken down on the basis of individual contracts.

Equally without merit is the court's attempt to distinguish the indivisible asset rule on the grounds that the rule does not apply to "binding agreements to pay money or render other valuable services," but does apply "to a class of asset like customer lists and to contracts which in practical effect are like customer lists". (I-R. 110.) The distinction is without substance, and, in any event, is inapplicable here. What the taxpayers acquired here was not an unrelated batch of individual contracts, but the customer structures of going-businesses. The Fourth Circuit aptly pointed out that "With a small loan company, its borrowers are its customers" * * * and "If its business is to

continue, relationships and dealings with those customers are essential". (United Finance, supra, p. 922.) There is no meaningful distinction between subscription lists, advertising contracts, supply contracts, service contracts, location leases, etc., and loan contracts. In each case, the asset purchased constituted all or a portion of the sales or customer structure of a business enterprise. That, *in substance*, is precisely what was purchased here, and the lower court erred in failing to recognize it.

CONCLUSION

For the foregoing reasons, the Tax Court's decision, that 70 percent of the premiums was attributable to the loan contracts and depreciable, is erroneous and should be reversed.

Respectfully submitted,

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OCTOBER, 1965.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ________________ day of ____________________, 1965.

____
RALPH A. MUOIO
Attorney

APPENDIX

EXHIBITS

Listed below are the exhibits offered and received as evidence in the Tax Court.

EXHIBIT NO.	VOLUME II OFFERED	RECEIVED
1 thru 77 (Attached to Stipulation)	36	36
78	61	65
79	86	88
80	101	104
81, 82, 83	105	106
84	125	128
85	141	147
86	141	147
87	200	225
88	235	238